

No. 10164

**In the United States Circuit Court of Appeals
for the Ninth Circuit**

GALLATIN FARMERS COMPANY, A CORPORATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

*ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES
BOARD OF TAX APPEALS*

BRIEF FOR THE RESPONDENT

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(I)



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OPINION BELOW

The memorandum opinion of the United States Board of Tax Appeals (R. 22-31) is not officially reported.

JURISDICTION

This petition for review (R. 32-36) involves federal income taxes for the taxable years 1938 and 1939. On April 2, 1941, the Commissioner of Internal Revenue mailed to the taxpayer notice of a deficiency in the total amount of \$512.44. (R. 5-6.) Within ninety days thereafter and on June 9, 1941, the taxpayer filed a petition with the Board of Tax Appeals for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code. (R. 1, 3-5.) The decision of the Board of Tax Appeals sustaining

the deficiency was entered on January 28, 1942 (R. 32.) The case is brought to this Court by a petition for review filed April 16, 1942 (R. 32-36), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTIONS PRESENTED

1. Whether the amount of \$798 paid by the taxpayer to its preferred stockholders in each of the years 1938 and 1939 represented dividends, or interest on indebtedness deductible by the taxpayer under Section 23 (b) of the Revenue Act of 1938.

2. Whether the Board was correct in disallowing \$3,485.93 of the amount claimed by the taxpayer as a deduction for patronage dividends in the year 1939.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447.

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest*.—All interest paid or accrued within the taxable year on indebtedness,

* * *

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend*.—The term “dividend” when used in this title * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out

of the earnings or profits of the taxable
year. * * *

* * * * *

Treasury Regulations 101, promulgated under the
Revenue Act of 1938:

ART. 23 (b)-1. *Interest.*—

* * * * *

So-called interest on preferred stock, which is
in reality a dividend thereon, cannot be deducted
in computing net income.

Revised Codes of Montana, 1935, c. 38:

SEC. 6379. Powers of such associations. Asso-
ciations formed under this act shall be bodies
corporate and politic for the period for which
they are organized * * *. They may borrow
money and may pledge their property, both real
and personal, to secure the payment thereof, and
they shall have and exercise all powers necessary
and requisite to carry into effect the objects for
which they may be formed, and such as are usu-
ally exercised by co-operative associations, sub-
ject to all duties, restrictions, and liabilities set
forth in the general laws in relation to similar
corporations, except so far as the same may be
limited or enlarged by this act.

* * * * *

SEC. 6381. Classes of stock—powers of stock-
holders of preferred and common stock—for-
feiture for non-payment of installments. The
shares of stock shall not be less than ten dollars
(\$10.00) nor more than five thousand dollars
(\$5,000.00) per share, and may be made payable
in installments. Every co-operative association
may divide its shares of stock into preferred and

common stock. The holders of preferred stock shall have no voting power and shall not participate in the management and affairs of the association, and the owners thereof shall share in the profits of the association to the extent of not exceeding six per cent. (6%) per annum on the par value thereof. The common stock may be divided into classes of different values, and the owners thereof shall share in the profits of the association in proportion to the par value of their shares; provided, however, that the owners of said common stock in the different classes shall have the same power and vote in the association. * * *

STATEMENT

The facts in this case were stipulated (R. 14-22), and are set out by the Board substantially as follows:

The taxpayer was incorporated and operates under the provisions of Chapter 38 of the Civil Code of Montana, with its principal place of business at Bozeman, Montana. (R. 23.) Its authorized capital, prior to January 18, 1938, was \$50,000 of common stock divided into seven different classes of varying par values. On that date the stockholders amended the articles of incorporation, so as to provide for \$30,000 of common stock of the same classes of varying par values as formerly, and in addition \$20,000 of preferred stock consisting of one class of 2,000 shares, par value \$10 per share. (R. 23.)

The resolution amending the articles of incorporation provided in part as follows (R. 23-24):

* * * Said preferred stock to be non-assessable, non-participating; annual dividends to be

cumulative and at the rate of six (6) per centum on the par value. Said preferred stock to be subject to call and redemption at par plus unpaid accumulated dividends at any time by order of the Board of Directors of said corporation. Upon dissolution or liquidation of this corporation said preferred stock shall be retired at par value plus accumulated dividends before any payment is made on common stock.

* * * * *

Motion was made * * *, and unanimously carried that the resolution be adopted as read, it being understood and explained that the preferred stock would be a debt of the Corporation, the dividend to be in the form of interest payable annually regardless of earnings, and that the Board of Directors could issue the preferred stock as they deemed necessary, and redeem it as the finances of the Corporation permitted.

Preferred stock was issued during 1938 pursuant to this amendment so that as of December 31, 1938 and 1939, there was preferred stock in the par value of \$13,300. (R. 24.) The face of the preferred stock certificates read as follows (R. 24-25):

GALLATIN FARMERS COMPANY

A COOPERATIVE ASSOCIATION

AUTHORIZED CAPITAL—COMMON \$30,000

PREFERRED \$20,000

This Certifies that _____ is the owner of ____ Preferred Shares of the Capital Stock of Gallatin Farmers Company, Belgrade, Montana transferable only on the books of the Corporation

by the holder hereof in person or by Attorney, upon surrender of this Certificate properly endorsed.

In Witness Whereof, the said Corporation has caused this certificate to be signed by its duly authorized officers and to be sealed with the Seal of the Corporation this ____ day of _____ A. D. 19__

Secretary.

President.

Shares
\$10
Each

Superimposed on the face of the certificate in large red letters is the word "Preferred". The back of the certificate reads as follows:

For Value Received, ____ hereby sell, assign, and transfer unto-----

Shares of the Capital Stock represented by the within Certificate, and do hereby irrevocably constitute and appoint -----
to transfer the said Stock on the books of the within named Corporation with full power of substitution in the premises.

Dated ----- 19__

In presence of

During each of the taxable years, 1938 and 1939, the taxpayer paid to its preferred stockholder the sum of \$798, which amount was deducted on its income tax return for each year as interest paid. These deductions were disallowed by the Commissioner on the ground that such sums constituted dividends and not interest. (R. 26.)

During 1939 the taxpayer declared and paid, out of prior years' earnings, a 6% dividend on its common stock for the year 1939, totaling \$1,183.20. (R. 26.)

The taxpayer reported an income for 1939, after deducting the \$798 paid on its preferred stock, of \$14,031.72. The Commissioner disallowed the claimed deduction of \$798 and adjusted the income to \$14,829.72. The Commissioner further held that before payment of patronage dividends the taxpayer must make provision for the following amounts (see Sec. 6381 of Revised Codes of Montana, 1935, *supra*) (R. 26):

6 per cent dividend on common stock-----	\$1, 183. 20
6 per cent dividend on preferred stock-----	798. 00
Provision for reserve fund	
5 per cent of \$12,848.52-----	642. 43
Provision for educational fund	
5 per cent of \$12,206.09-----	610. 30

The surplus (reserve) of the taxpayer as of December 31, 1939, prior to the deduction therefrom of the common stock dividend of \$1,183.20, the payment on preferred stock of \$798 and the inclusion therein of profit or deduction therefrom of any loss from operations for 1939, is the amount of \$7,910.18. (R. 26-27.)

No amount was set aside from current earnings in 1939 as an addition to the reserve, and no amount has ever been set aside as an educational fund. (R. 27.)

The Board of Tax Appeals sustained the Commissioner's determination of deficiencies for the years 1938 and 1939 (R. 32), and the taxpayer brings the case to this Court for review.

SUMMARY OF ARGUMENT

Whether preferred stock of a corporation represents "indebtedness" or an interest in the corporation de-

pend upon the facts in each case. The terms "dividend" and "preferred stock" are not conclusive, but they are significant in determining the purpose of the parties using them. "Interest" as used in Section 23 (b) means the sum which is paid for the use of borrowed money.

The instruments here were called "preferred stock" and have the other usual indicia of stock certificates rather than certificates of indebtedness. The statute of Montana under which the taxpayer was incorporated permitted it to borrow money without the necessity of revamping its capital structure and issuing preferred stock. The issuance of preferred stock is a common method by which a corporation obtains necessary funds without incurring a debt.

Section 115 (a) defines the term "dividend" to mean any distribution made by a corporation to its stockholders out of its earnings or profits. The payments to the preferred stockholders here meet that definition, and also the requirement of the Montana statute that preferred stockholders shall share in the profits of the association. The stock certificates provided that the dividends should be "cumulative," further indicating they were to be made only from earnings and profits. The stock certificates in this case had no fixed maturity date, but were subject to the usual corporate process of call and redemption at any time by order of the board of directors.

The taxpayer has not pointed to any revenue statute authorizing any deduction whatever for patronage dividends; neither has it shown that the administrative

officer, within whose discretion such deductions have been permitted, may not require the corporation to comply with state statutory plans for reserves before such deductions are allowed. Whether and to what extent deductions shall be allowed depends upon legislative grace, and only as there is clear provision therefor can any particular deduction be allowed.

ARGUMENT

I

The amounts paid to its preferred stockholders by the taxpayer during the taxable years were dividends and not interest

Section 23 (b) of the Revenue Act of 1938, *supra*, allows a corporation in computing its net income to deduct all interest paid or accrued within the taxable year on indebtedness. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. Art. 23 (b)-1 of Treasury Regulations 101, *supra*; *Pacific Southwest R. Co. v. Commissioner*, 128 F. 2d 815, 817 (C. C. A. 9th). The taxpayer in this case is claiming a deduction for the taxable years 1938 and 1939, of the amounts paid its preferred stockholders during those years, on the theory that the certificates represented indebtedness. The Government takes the position that the certificates were what they purported to be, preferred stock certificates, and that the payments in question were dividends.

Various factors, no particular one of which can be said to be controlling, have been considered by the courts in arriving at a determination of whether pre-

ferred stock of a corporation may represent “indebtedness” within the meaning of the Revenue Act so that a corporation is entitled to a deduction for interest in the amount of the dividends paid. Each case depends upon its own particular facts. *Commissioner v. Schmoll Fils Associated*, 110 F. 2d 611 (C. C. A. 2d).

While the use of terms “dividends” and “preferred stock” is not conclusive, nevertheless when such terms are used it cannot be inferred that they have been improperly used unless there is clear and convincing evidence to that effect. As stated in *Matthews v. Bradford*, 70 F. 2d 77, 78 (C. C. A. 6th):

“While the designating of securities as preferred stock is not conclusive upon the status of the holder, yet what the parties in a given case have called the subject of the contract is of no little significance in determining their purpose, and, where the purpose authorized and the purpose declared is an issue of stock and not the creation of a debt, the intention to create a debt should be clear and convincing; * * *.”

The term “interest” as used in Section 23 (b), means the sum which is paid for the use of borrowed money. *Deputy v. duPont*, 308 U. S. 488; *Old Colony R. Co. v. Commissioner*, 284 U. S. 552. Thus, in order to show that the taxpayer paid interest within the meaning of the revenue statutes to the holders of its preferred stock, it must necessarily appear that such holders had loaned the taxpayer money and that there was a debtor-creditor relationship, instead of one arising by reason of an investment in a corporation.

In the instant case the designation of the certificates in question was plainly and unqualifiedly “preferred

stock.” As pointed out by the Board, there was nothing in the amendment of the articles of incorporation nor in the preferred stock certificates themselves to indicate they were anything except what they were called and what they purported to be. The certificates on their face contain the usual recitals of the amount and type of the taxpayer’s authorized capital stock, that the party whose name appears on the face is the owner of a stated number of preferred shares of the stock, and that the stock was transferable on the books of the taxpayer in the ordinary manner. On the back of the certificate appears the usual form of endorsement over of the certificate. Further, these certificates met every requirement for preferred stock under Section 6381 of the Revised Codes of Montana, 1935, *supra*. That section authorizes cooperative associations to divide their capital stock into shares of common and preferred, the par value of the preferred to be not less than \$10. It also provides that the holders of preferred stock shall have no voting power and shall not participate in the management and affairs of the association, but also provides that the owners of the preferred stock “shall share in the profits of the association to the extent of not exceeding six percent (6%) per annum on the par value thereof.” (R. 28.) It seems clear that a stockholder, rather than a creditor, relationship was contemplated throughout the transaction here.

Section 6379 of the Revised Codes of Montana, 1935, *supra*, authorized cooperative associations to borrow money and pledge their property to secure the payment thereof, and to exercise all powers necessary and requi-

site to carry into effect the objects for which they were formed. It does not appear, then, that it would have been necessary for the taxpayer to amend its articles of incorporation and go through the formality of re-vamping its capital structure and issuing preferred stock, if its only purpose was to borrow money and create a debtor-creditor relationship.

The issuance of preferred stock is, of course, a common means by which a corporation obtains property or funds for its enterprises without borrowing money or incurring a debt. As was stated by this Court in *Elko Lamoille Power Co. v. Commissioner*, 50 F. 2d 595, 596:

A preferred stockholder is a mode by which a corporation obtains funds for its enterprise without borrowing money or contracting a debt, the stockholder being preferred as to principal and interest, but having no voice in the management. * * * It differs only from other stocks in that it is given preference and has no voting right. A preferred stockholder is not a creditor of the company.

In Section 115 (a) of the Revenue Act of 1938, *supra*, Congress defined the term "dividend" to mean any distribution made by a corporation to its stockholders out of its earnings or profits. Interest may be paid from *any* assets of a corporation. The payments in question here were made out of earnings or profits of the corporation. It was stipulated that \$1,183.20 was paid on common stock in 1939 "out of prior years' earnings" (R. 16), and that the 1939 net income, after deducting the \$798 paid on the preferred, was in excess of

\$14,000. The payments to the preferred stockholders in this case therefore meet the definition of “dividends” in the revenue statutes. They also meet the provisions of the Montana statute that preferred stockholders shall share in the “profits of the association” not exceeding 6% per annum of the par value, which was the exact amount that was paid to the preferred stockholders in this case.

Another fact tending to prove that payments here were to be made only out of earnings is the statement in the resolution of the taxpayer corporation authorizing the issuance of preferred stock to the effect that annual dividends thereon should be “cumulative.” (R. 23.) As ordinarily used in connection with corporate distributions on preferred stock, the word “cumulative” means that if in any one year there are insufficient *earnings* to pay the amounts stipulated to be paid, they are to be paid in a subsequent year or years out of earnings, if any, before dividends are paid on common stock. If the word “cumulative” had been left out it would have been indicative of an intention to pay the preferred stockholders out of any assets, regardless of earnings. Its inclusion tends to prove the contrary.

Finally, there was no fixed date of maturity for the preferred stock certificates in this case. This is additional evidence that the owners of the certificates were stockholders of the corporation and not creditors. In *Brown-Rogers-Dixson Co. v. Commissioner*, 122 F. 2d 347, 350 (C. C. A. 4th), it was stated:

There was no due or maturity date fixed for the payment of the principal. It has been re-

peatedly held that one of the fundamental characteristics of a debt is a definite determinable date on which the principal falls due. *Elko Lamoille Power Co. v. Commissioner*, 9 Cir., 50 F. 2d 595; *Commissioner v. Proctor Shop*, 9 Cir., 82 F. 2d 792; *Dayton & Michigan R. Co. v. Commissioner, supra*; *United States v. South Georgia Ry. Co.*, 5 Cir., 107 F. 2d 3; *Commissioner v. Schmoll Fils Associated*, 2 Cir., 110 F. 2d 611.

In the *South Georgia* case the Court stated: “* * * There is, thus, an entire absence of the most significant, if not the essential feature of a debtor and creditor as opposed to a stockholder relationship, the existence of a fixed maturity for the principal sum with the right to force payment of the sum as a debt in the event of default.”

The preferred stockholders here had no rights to demand payment at any particular time. The stock was subject to the usual corporate process of call and redemption at any time by order of the board of directors of the corporation.

The taxpayer admits (Br. 9) that the wording on the certificates and the amendment to the charter authorizing the issue would indicate that this was an issue of stock and nothing else. The only evidence presented by the taxpayer in support of its contention that the certificates represented an “indebtedness” is a notation in its minutes reading (R. 24) “it being understood and explained that the preferred stock would be a debt of the Corporation, the dividend to be in the form of interest payable annually regardless of earnings, * * *.” In *Elko Lamoille Power Co. v. Commis-*

sioner, *supra*, the preferred stock of the taxpayer was sold on oral representation that the holders could return it at any time and receive the amount paid together with accumulated dividends. Upon refusal of the revenue officers to recognize the preferred stock as a debt and the dividends thereon as interest, the corporation adopted a formal resolution ratifying and confirming the oral representations with respect to redemption, and declaring the certificates of preferred stock to be certificates of indebtedness. This Court held the collateral agreement between the officers and the stockholders, and the resolution passed after the sale of the preferred shares had no probative value, and rejected the taxpayer's contention that its preferred stock represented an indebtedness of the corporation, quoting (p. 597) from *Warren v. King*, 108 U. S. 389, 396: "The rights of the holders of preferred stock in this case must be determined by the language of the stock certificates."

The taxpayer relies on the cases of *Commissioner v. Proctor Shop*, 82 F. 2d 792 (C. C. A. 9th), and *Arthur R. Jones Syndicate v. Commissioner*, 23 F. 2d 833 (C. C. A. 7th), in support of its contention that its preferred stock certificates represented indebtedness. The findings in those cases on the whole evidence showed the real intent of the parties to be the creation of a debtor-creditor relationship; and in further evidence of this fact there was a fixed redemption date for the shares in each case. In the *Proctor Shop* case, in order to avoid affecting the credit of the corporation there was issued "debenture preference stock" for the amounts advanced to the corporation by one who was unwilling to

become an investor in it. In the *Arthur R. Jones Syndicate* case, it was definitely shown that the reason for calling the instruments "preferred stock" was to avoid a usury statute.¹

In the instant case there was no evidence of any necessity to create a debtor-creditor relationship rather than stockholder; there was no usury law to be avoided, and nothing whatever to indicate anything out of the ordinary and usual relation in the issuance of the preferred stock. The taxpayer has presented no testimony of holders of the certificates to indicate they considered themselves creditors rather than stockholders. There is no showing that the payments were carried on taxpayer's books as interest payments rather than dividends. In the absence of such evidence it must be assumed taxpayer had none to offer.

It is therefore submitted that the taxpayer has failed to show that the preferred stock certificates here were anything other than what they purported on their face to be, or that the payments to the holders of these certificates were anything other than dividends. The claimed deduction should therefore be denied. *Elko Lamoille Power Co. v. Commissioner, supra; In re Culbertson's*, 54 F. 2d 753 (C. C. A. 9th).

¹ We question the correctness of the *Arthur R. Jones Syndicate* case. There the contract took its form in order to avoid a usury statute. If the payments there had been interest, they would have been usurious and there would have been no obligation to pay. Hence they would not have been deductible. The corporation was obligated to make the payments only if they were in fact dividends.

II

The Board was correct in disallowing the additional deduction claimed by the taxpayer for patronage dividends for 1939

During the year 1939 the taxpayer accrued on its books as patronage dividends the sum of \$14,860.30, which was paid subsequent to December 31, 1939. The Commissioner disallowed \$3,485.93 of this amount as excessive, holding that before patronage dividends were paid provision must be made for dividends on common and preferred stock, for the reserve fund and for an educational fund, in accordance with the percentages outlined in the Montana statute under which the taxpayer was incorporated. (R. 26; taxpayer's Br. 6.) The taxpayer contends it is entitled to deduction of the entire amount claimed as patronage dividends.

As plainly stated by this Court in *Co-Operative Oil Ass'n. v. Commissioner*, 115 F. 2d 666, 668, there is no statutory provision permitting the deduction of so-called patronage dividends, but the *administrative practice* has been to permit cooperative associations, even though not exempt from taxation, to deduct from gross income the amounts returned to their patrons, upon the basis of the purchases or sales, or both, made by or for them.

The findings of the Board indicate the taxpayer had not made provision for common stock dividends for 1939, nor for the reserve fund and educational fund, out of the earnings for that year, in accordance with the plan set out in the Montana statutes relating to corporations of this type. Whether these provisions of the

Montana statute were “permissive” or “mandatory” is not material here. The taxpayer has not pointed to any revenue statute authorizing the deduction claimed; neither has it shown that the administrative officer, within whose discretion such deductions have been permitted, may not require that the plan laid down in the state statute under which the taxpayer was incorporated, be complied with before patronage dividends may be allowed.

The position of the taxpayer here, claiming a greater deduction for patronage dividends than that allowed by the Commissioner, can best be stated by quoting from the opinion of this Court in *Co-Operative Oil Assn. v. Commissioner, supra*, p. 668:

In other words, petitioner points to no statute authorizing any deduction whatever, and we are in effect asked to hold that a practice of respondent permitting a deduction not authorized by statute, is not liberal enough. We know of no manner in which such liberality may be reviewed in this court. It is familiar law that “Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed” and “a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.” *New Colonial Ice Co. v. Helvering*, 292 U. S. 435, * * *. See also: *White v. United States*, 305 U. S. 281, 292, * * *.

It is therefore apparent that the Board committed no error in denying the taxpayer’s claim for this additional deduction.

CONCLUSION

It is respectfully submitted that the decision of the Board is correct and that it should be affirmed.

Respectfully submitted,

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SEPTEMBER, 1942.

